No. 17554

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

THE CENTURY INDEMNITY COMPANY, a corporation,

Appellant,

vs.

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

Appellee.

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

Appellant,

vs.

THE CENTURY INDEMNITY COMPANY, a corporation,

Appellee.

On Appeal From the Judgment of the United States District Court for the Southern District of California.

BRIEF FOR APPELLANT AND CROSS-APPELLEE.

[illegible]
[illegible]
[illegible] West Sixth Street,
Los Angeles 17, California,
Attorneys for Appellant and Cross-Appellee.

[illegible]

TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Miscellaneous

Statutes

No. 17354

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

THE CENTURY INDEMNITY COMPANY, a corporation,
Appellant,

vs.

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,
Appellee.

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,
Appellant,

vs.

THE CENTURY INDEMNITY COMPANY, a corporation,
Appellee.

On Appeal From the Judgment of the United States District Court for the Southern District of California.

BRIEF FOR APPELLANT AND CROSS-APPELLEE.

Opinion Below.

The opinion of the District Court is reported at Par. 9140, 61-1 USTC, and pages 326-328 of the Transcript of Record. References to the opinion herein will be to pages of the Transcript of Record.

Jurisdiction.

The Taxpayer's appeal is taken from a portion of a decision and judgment of the United States District for the Southern District of California, Central Division. Its appeal involves Withholding tax on wages of employees of its principal, a subcontractor, under a

surety bond for the period between March 9, 1954, and September 17, 1954 [R. 96], in the amount of $17,-830.66, plus interest.

The Government's appeal involves Federal Insurance Contributions Act taxes, delinquency penalty and interest in the amount of $10,278.37, plus interest; Federal Unemployment Act taxes and interest in the amount of $4,113.39, plus interest; Withholding tax on wages, delinquency penalty and interest for the period between December 7, 1953 and March 8, 1954, in the amount of $8,383.10, plus interest; and the Order Re-Taxing Costs in the amount of $188.50. [R. 97.]

All the above taxes were assessed against the Taxpayer and paid under protest. [R. 52-55.] The Taxpayer filed three timely claims for refund on January 7, 1958, as follows: Withholding tax for the period from October 1, 1953, to September 30, 1954, in the amount of $26,213.76; Federal Insurance Contributions Act taxes for the period from October 1, 1953 to September 30, 1954, in the amount of $10,278.37; and Federal Unemployment Tax for the period from January 1, 1954 to December 31, 1954, in the amount of $4,113.39. No action was taken with respect to any of the three claims for refund within six months from date of filing. [R. 57.] The Taxpayer thereupon filed a complaint against Robert A. Riddell, District Director of Internal Revenue for the Los Angeles District of California in the District Court for the Southern District of California on October 7, 1958, for refund of said amounts which it alleged had been illegally assessed and collected and thus overpaid. [R. 3-35.] Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340. Judgment was entered

partially in favor of the Taxpayer and partially in favor of the Government on December 5, 1960. [R. 88-89.] Within 60 days both the Taxpayer and the Government filed notices of appeal, on February 2, 1961, and February 3, 1961, respectively. [R. 96-98.] Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

Question Presented.

On the Taxpayer's Appeal:

The Taxpayer and its principal under a surety bond, a subcontractor, established a joint control bank account. All progress payments under the subcontract were deposited in this bank account. For the period between December 7, 1953, and March 8, 1954, the Taxpayer's representative, as trustee, countersigned one check drawn on this account to cover the subcontractor's payroll for the period covered. This check was then deposited in the subcontractor's Commerical checking account. Individual payroll checks were then issued by the subcontractor to its employees. Some of these checks were drawn on the joint control account and some on the subcontractor's Commercial checking account, but none of these checks was countersigned by a representative of the Taxpayer.

The District Court held that during this period the Taxpayer was not the "employer" of the employees of the subcontractor within the meaning of Sections 1621(d), 1622(a) and 1623 of the 1939 Code and was not liable for Withholding tax of the subcontractor for that period. [R. 87.]

For the period between March 9, 1954, and September 17, 1954, the Taxpayer's representative counter-

signed the individual payroll checks prepared by the subcontractor and which were all drawn on the joint control account with minor exceptions not here material.

The District Court held that for this period the Taxpayer was the "employer" for Withholding tax purposes within the meaning of the applicable Code sections and was liable for the Withholding taxes of the subcontractor for that period. [R. 87.]

Only one question is presented by the Taxpayer's appeal:

Did the District Court err in holding that the Taxpayer was the "employer" of the employees of the subcontractor for the period between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a), and 1623 of the Internal Revenue Code of 1939, as amended, and thus liable for the Withholding taxes on the wages of such employees?

Statutes and Regulations Involved.

The pertinent provisions of the statutes and Treasury Regulations are printed in the Appendix, *infra*.

Statement of the Case.

The significant facts pertinent to the Taxpayer's appeal, as stipulated by the parties [R. 46-47], as found by the District Court [R. 81-85], and as set forth in the testimony may be summarized as follows:

On October 6, 1953, White-Ahlgren Company, Inc. (herein sometimes referred to as "Subcontractor") entered into a subcontract with Marine Development, Inc. (herein sometimes referred to as "Contractor") for concrete work in connection with the building of a 1,000 unit Wherry Housing Project at Camp Pendleton, Cali-

fornia, for $549,138.20. This contract provided for monthly progress payments based on the percentage of works performed, less 10% and less all previous payments. Upon acceptable completion of the work and a proper showing by the Subcontractor that all materialmen and laborers had been paid, the 10% retained and any other payments due were payable to the Subcontractor. The contract also required Subcontractor to pay all social security and other taxes imposed on Subcontractor as employer in connection with the labor provided by Subcontractor under the contract and required Payment and Performance Bonds in the full amount of the contract. [Pltf. Ex. 1-B.] As a result of subsequent changes and adjustments, the final amount payable to Subcontractor under the contract was $551,-131.73. [R. 50.]

On October 6, 1953, the same date the subcontract was entered into, Subcontractor executed an Application for Contract Bond and Indemnity Agreement through the Cole Insurance Agency, Inc. of Los Angeles, an authorized agent of the Taxpayer. [Pltf. Ex. 2.] Upon receipt of said application the Taxpayer determined that Subcontractor was under-financed. By letter dated November 16, 1953, addressed to Contractor, the Taxpayer, through D. J. Waite, Attorney-in-Fact, stated, on the subject of adequate financing, that it would issue Subcontractor a bond upon receipt of $25,000.00 in cash by Subcontractor, which was anticipated to be put in the corporation by November 25, 1953, and an advance payment of $10,000.00 by Contractor, which specific sum of money was to be deposited in a special bank account of Subcontractor of which the Taxpayer, as surety, would have joint control. [Deft. Ex. A; R. 74-75.]

A Contract Bond was executed December 2, 1953. [Pltf. Ex. 3.] The application for the bond contained a provision in section Fourth that the Taxpayer, as surety, should be subrogated to all rights of Subcontractor in the contract and an assignment of all deferred payments and retained percentages arising out of the contract. The bond provided that if the Subcontractor defaulted in the performance of the contract, the Taxpayer, as surety, had the right, at its option to proceed or procure others to proceed with the performance of the contract.

On December 2, 1953, Subcontractor opened a commercial checking account in the Security Trust and Savings Bank of San Diego, California, known as "White-Ahlgren Trust Account No. 1," over which Subcontractor and the Taxpayer, as surety on the bond, would have joint control. The resolutions and signature cards filed with the bank required all checks drawn against this account to be signed by an authorized signatory of Subcontractor and to be countersigned by any one of several designated representatives of the Taxpayer, who was to sign as trustee. [R. 83.]

Except for retention payments withheld by Contractor pursuant to the contract in the sum of $54,-249.18 and paid directly by Contractor to the Taxpayer on December 17, 1954, all progress payments made by Contractor under the subcontract were required to be and were deposited in this Trust Account No. 1. [R. 83.]

Subcontractor also had a general commercial account at the same bank with which the Taxpayer had no connection. [Pltf. Ex. 5.] During the months of December, 1953, and January and February, 1954, this

account was used for the payroll for a contract Subcontractor had with Webb & Knapp. The account was closed in August, 1954. [R. 312-313.]

On the same day that Trust Account No. 1 was opened $25,000.00 was deposited in this account of which $10,000.00 was advanced by Contractor and $15,000.00 was a loan to Subcontractor by Hertha A. Clausen. She had agreed to loan Subcontractor $15,000.00 provided this money and an additional $10,000.00 would be put under joint control. [R. 105.] This amount was $10,000.00 less than the required minimum as set forth in Mr. Waite's letter [Deft. Ex. A] but was all deposited in the joint control account whereas he had stated that only the $10,000.00 advanced by Contractor had to be under joint control. [R. 184-188.] As of December 1, 1953, the balance in Subcontractor's general commercial account was $9,992.92. [Deft. Ex. E.]

This Trust Account No. 1 continued in existence until December 6, 1954, and was at all times a joint control account.

Work under the subcontract began about December 7, 1953 [R. 83] and was completed by Subcontractor on September 17, 1954. [R. 84.] However, in March, 1954, Subcontractor had fallen behind in the specified rate of performance. Contractor called a meeting at Camp Pendleton at which Eva L. Cole was present as a representative of the Taxpayer. [R. 119-120.] As a result of this conference, Contractor's attorney wrote Mrs. Cole a letter dated March 23, 1954, wherein Contractor agreed to modify the contract to the extent of changing the scheduled rate of performance and of making progress payments on a weekly rather than a month-

ly basis. This letter also stated that the Taxpayer, within 24 hours after receipt of written request from Contractor should take over the subcontract. Except as so modified the subcontract and bond were to remain in full force and effect. [Pltf. Ex. 10.] Upon receipt of this letter by Mrs. Cole, it was turned over to Mr. Burton A. Van Tassel, local counsel for the Taxpayer. He shortly thereafter superseded Mrs. Cole as the representative of the Taxpayer in connection with the subcontract. [R. 120-121.] The letter from Mr. Oakes, the attorney, provided for its approval and agreement by the Taxpayer. However, it was never so approved as the new arrangement was working out, there was no emergency, and approval by the Taxpayer was not insisted upon. [R. 235-238; 259-261.] The Subcontractor continued to perform under the contract, as modified, until its completion. [R. 203-210.]

About the middle of February, 1954, Subcontractor determined that it had underbid on the subcontract. The plans and specifications on which estimates were based showed that garages and driveways were to be of asphalt construction, but the set of plans given to Contractor showed them to be concrete. Subcontractor thus had to pour 2,100 yards of concrete, plus the labor, plus the extra materials that went with it. [R. 224-225.]

Subcontractor became unable to pay all materialmen and incidental labor in connection with the subcontract. The Taxpayer paid said creditors the total sum

of $119,188.17 [Pltf. Ex. 20] and made recoveries in connection with claims asserted under the terms of the bond in the amount of $70,723.84. [Pltf. Ex. 1-A.]

The Taxpayer never paid or advanced any of its own funds to meet the payroll of the Subcontractor except for $1,090.00 deposited in Trust Account No. 1 in September, 1954, to enable Subcontractor to meet in full its final payroll upon completion of the subcontract. [R. 51.]

Payrolls: The Subcontractor's payrolls were prepared and checks were issued for its employees in substantially the following manner:

Beginning with the subcontract, Mrs. Higgins, bookkeeper for the Subcontractor, prepared weekly payroll sheets. The foreman delivered the time cards and from them Mrs. Higgins computed the hours, rate of pay, applicable deductions, and the net figure. She then transferred this information to a recap sheet. [R. 303-4; Deft. Ex. X.] A check in the gross amount of each weekly payroll payable to Subcontractor and drawn on Trust Account No. 1 was duly signed by an authorized signatory of Subcontractor and countersigned by a duly authorized representative of the Taxpayer for the period between December 7, 1953, and January 11, 1953, and a similar check in the net amount of the payroll (gross amount less deductions) was issued for the period between January 12, 1954, and March 8, 1954. [R. 84; 109-110.] This check was deposited in Subcontractor's regular commercial ac-

count. Individual payroll checks were then made out by Subcontractor and delivered to its employees. However, instead of the individual payroll checks being drawn on Subcontractor's general account as intended, Subcontractor at first drew a number of individual checks on Trust Account No. 1, which were honored by the Bank although not countersigned by Taxpayer's representative as required [R. 199-201.] A total of 148 checks in the amount of $9,630.18 were so written and paid before this was discovered. The dates of these checks were from December 18, 1953, through January 8, 1954. [Pltf. Ex. 36.] By letter to the bank dated January 15, 1954, the Taxpayer's representative confirmed a prior telephone conversation and ratified the payment of these checks without the required countersignature. [Pltf. Ex. 25; R. 113-115.] Thereafter for each weekly payroll between January 12, 1954, and March 8, 1954, the same arrangement was continued except that the single payroll check written on Trust Account No. 1 and deposited in Subcontractor's general account was for the net rather than the gross amount of the payroll.

For the period above referred to the District Court held that the Taxpayer was not the "employer" for Withholding tax purposes and was not liable for the Withholding tax of the Subcontractor's employees.

Commencing on March 9, 1954, and ending with the completion of the subcontract on September 17, 1954, wage payments were made weekly to the employees of

Subcontractor directly from Trust Account No. 1. These payments were made by individual checks drawn against Trust Account No. 1 payable to the order of each individual employee in the net amount due. Each check was signed by an authorized signatory of Subcontractor and was countersigned by a duly authorized representative of the Taxpayer, who countersigned as trustee. [R. 84-85.]

During this period the procedure was for the Subcontractor's bookkeeper to prepare a recap sheet and individual payroll checks. The Taxpayer's representative went to Subcontractor's office each week, compared the individual checks with the recap sheet, then countersigned them as trustee. [R. 239-240; 306.]

The only job being performed by Subcontractor during this time was the subcontract here in question, and Subcontractor received no funds from any other contract. [R. 85.]

For the period above referred to the District Court held that the Taxpayer was the "employer" for Withholding tax purposes and was liable for the Withholding tax of the Subcontractor's employees.

Specifications of Error.

The specifications of error relied upon by the Taxpayer are as follows:

1. That the District Court erred in its finding that Taxpayer had control of the payment of the wages of the employees of White-Ahlgren Company, Inc., for

the services rendered by said employees between March 9, 1954, and September 17, 1954. [R. 85];

2. That the District Court erred in its finding that Taxpayer was the "employer" of the employees of White-Ahlgren Company, Inc., between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a) and 1623 of the 1939 Internal Revenue Code, as amended [R. 87]; and

3. That the District Court erred in its Judgment that Taxpayer take nothing with respect to Withholding taxes and interest paid by Taxpayer to Defendant for the period between March 9, 1954, and September 17, 1954. [R. 88.]

Summary of Argument on the Taxpayer's Appeal.

1. The individuals performing services in connection with the subcontract were performing them for the Subcontractor and not for the Taxpayer.

2. The subcontractor and not the Taxpayer had control of the payment of the wages for such services within the meaning of Section 1621(d)(1) of the Internal Revenue Code of 1939, as amended. For the Taxpayer to have had control of the payment of the wages within the meaning of the statute, and as held in this Circuit, the Taxpayer would have had to have exclusive rather than merely joint control of such payments. A control "which is equal to the veto power" is not the control required under Section 1621(d) to make a person the employer as held by the District Court.

ARGUMENT.

I.

The Individuals Performing Services in Connection With the Subcontract Were Performing Them for the Subcontractor and Not for the Taxpayer.

It is abundantly clear from the record, and the District Court found, that the Subcontractor completed the subcontract in question and that all services of employees in connection with the subcontract were performed by them for and on behalf of the Subcontractor. Therefore, without belaboring this point, suffice it to say that the Taxpayer was not the employer within that portion of the statutory definition which states:

> "The term 'employer' means the person for whom an individual performs or performed any services, of whatever nature as the employee of such person, * * *"

II.

The Subcontractor and Not the Taxpayer Had Control of the Payment of the Wages for Such Services Within the Meaning of Section 1621(d)(1) of the Internal Revenue Code of 1939, as Amended. For the Taxpayer to Have Had Control of the Payment of Wages Within the Meaning of the Statute, and as Held in This Circuit, the Taxpayer Would Have Had to Have Exclusive Rather Than Merely Joint Control of Such Payments. A Control "Which Is Equal to the Veto Power" Is Not the Control Required Under Section 1621(d) to Make a Person the Employer as Held by the District Court.

Before analyzing the law on this point, a prefatory comment would appear pertinent. The Treasury Department is understandably concerned with collecting taxes properly owed. The tax withheld from the income of employees is, of course, in this category. The person who is the "employer" of such employees has the legal obligation to pay such withheld taxes. Cases such as the present case present a difficult problem. Although relatively few in number in relation to the huge volume of such contracts, they have arisen with sufficient frequency to spotlight the difficult problems involved. They do not arise unless something has gone wrong. In short, there is not enough money to go around. Who is going to stand the loss? Here, for example, the Government admittedly did not receive the tax money due it. The Taxpayer, as surety, also lost substantial sums. In such a situation, and as the Government will urge on its appeal, there is an inevitable tendency to urge that the equities are such that

the bonding company, rather than the public revenues, should bear the tax loss. As this cannot be accomplished as a matter of law by holding the surety liable for payroll and withholding taxes under its bond, the argument is made on factual grounds. The position urged is that the surety, or prime contractor as the case may be, has money. The subcontractor does not. Therefore, the latter is in "control" of the payment of the wages under the theory that a "trust fund" is created by statute. This was the position urged upon and adopted by the District Court in *United States v. Swedlow Engineering Co.,* 100 Fed. Supp. 796 (S. D. Cal. 1951). Judge Yankwich reasoned that "without the periodic drafts [of the bonding company] to cover them [the wages] could not have been paid." On appeal this decision was reversed by this Court in a *per curiam* opinion, *sub. nom., Fireman's Fund Indemnity Co. v. United States,* 210 F. 2d 472 (9th Cir. 1954). Nonetheless the rationale behind the lower Court's decision is still, in effect, being urged by the Government.

This is further illustrated by the "Order For Judgment in Favor of Plaintiff" in *Reliance Insurance Company v. United States,* ..... Fed. Supp. ..... (N. D. Cal. 1959; Civil Action No. 37234; 60—1 U. S. T. C. Par. 9315). This case is practically on all fours with this Taxpayer's case. In ordering judgment in favor of plaintiff, and the Government took no appeal, Judge Harris stated:

> "* * * The legal principles, contained in the statutory definition itself and established by case law, have construed the term 'employer' in a manner which excludes a corporation in plaintiff's posi-

tion from being encompassed within the scope of Section 1621. (a) *Phinney v. Southern Warehouse,* 212 F. 2d, 448; (b) *William Simpson Const. Co. v. Westover,* 100 F. Supp. 125, Aff. 209 F. 2d, 908 (9); (c) *American Fidelity Co. v. Delaney,* 114 F. Supp. 702.[1] Any departure from a strict application of the controlling principles in these decisions, regardless of the equities, results in quick reversal *(Fireman's Fund v. United States,* 100 F. Supp. 796)."

The Judge then went on to say:

"However unconscionable plaintiff's conduct may be in avoiding a just obligation due the government for withholding and social security taxes owed employees of Coast Pipeline, nevertheless defendant cannot prevail under the evidence before the court. Instead, the government must look to relief —at least in the future—through legislative remedies which have long since been enacted by California state authorities to protect tax obligations of a like character."

Despite the obviously strong feelings of the Judge he was impelled, on the basis of the law, to decide the case in favor of plaintiff, the bonding company, and to hold that it was not the employer. This will be discussed later. The case is referred to here to illustrate a point

---

"[1](a) Bonding company paying employees of contractor held not 'employer'

(b) Contractor held entitled to recover taxes collected on wages paid subcontractor's employees.

(c) Bonding company, though assisting financially in completion of project, held not to be 'employer' for tax liability."

[A certified copy of the opinion is reproduced in full in the appendix.]

that counsel frankly is unable to grasp. Just why is it "unconscionable" for a person to ask that his tax liability be determined in accordance with the law? Why is he "avoiding a just obligation due the government" when Congress and this Court have stated that he does not have such an obligation?

Congress did in fact give extensive consideration to the problem of securing greater compliance with the law on the part of employers and others in paying over to the Government trust fund moneys withheld from employees, or collected from customers. It enacted P. L. 85-321, effective February 12, 1958. Section 1 added Section 7512 and Section 2 added Section 7215 to the Internal Revenue Code. The remedy adopted by Congress was to provide that where a person fails to collect and pay over the taxes the Internal Revenue Service can require him to deposit such taxes in a special trust account not later than the end of the second banking day after any amount of such taxes is collected and to provide criminal penalties for failure to do so. In the Senate Report explaining these provisions the following paragraph appears:

> "Present law in section 6672 provides a civil penalty of 100 percent for any person who willfully fails to collect or truthfully account for and pay over an internal-revenue tax for which he is responsible. However, this civil penalty is ineffective where the employer has lost the employees' funds in a business venture or where he did not have them in the first place. The latter, which presents one of the most difficult enforcement problems, can be illustrated by a secondary contractor who is without funds, but obtains from the prime

> contractor just enough to meet his net payroll. The prime contractor in this case, since he is responsible for the completion of the job, is willing to provide the net wage payments, but since he is not the 'employer' cannot be required to provide the taxes to be withheld by the 'employer.' The secondary contractor who is the 'employer,' apart from the net wage payments, does not have any funds in these cases to set aside as withheld taxes." [S. Rep. No. 1182, 85th Cong. 2d Sess. (1958), 1958—Cum. Bull. 641.]

It is thus clear that Congress was fully cognizant of the problem presented by the situation giving rise to the case now before this Court. Whatever the reason, Congress did not choose to make a surety or a prime contractor the employer liable for payroll and withholding taxes in this type situation. It adopted other remedies and left the then and now existing law with respect to the definition of an employer unchanged.

What is the law?

It is respectfully submitted that the law is quite clear. For the Taxpayer in this case to have had "control" over the payment of the wages of Subcontractor's employees within the meaning of Section 1621(d)(1) and to render this exception to the general definition of "employer" applicable, two things must be shown: (1) that the Subcontractor had no control over the payment of the wages, and (2) that the Taxpayer had. *Westover v. William Simpson Const. Co.*, 209 F. 2d 908 (9th Cir., 1954). Obviously this was not the case. A joint control or "veto power" is not sufficient.

Here the Taxpayer was not advancing its own money to the Subcontractor except for $1,090.00 advanced for

the final payroll. What it did was to countersign checks so as to be certain that the Contractor's progress payments were properly expended in connection with the subcontract for which the progress payments were made and that the money was not improperly expended or otherwise dissipated for unrelated purposes.

In the opinion of the District Court, Judge Hall stated that for the period to March 18 [when one countersigned check was written to cover the payroll] the taxes came clearly within the *Simpson* case and the *Fireman's Fund* case. However, for the subsequent period when individual payroll checks were countersigned by the Taxpayer's representative, the Taxpayer had a veto power and thus "control."

Counsel have endeavored in vain to find any legal distinction based on this factual difference. What is the difference from the standpoint of the requisite statutory "control" between countersigning one check for the net amount of the payroll and countersigning individual payroll checks in the same net amount? It is respectfully submitted that there is none.

In the *Fireman's Fund* case in Paragraph VII of the Stipulation of Facts the procedure used was stipulated as follows:

> "* * * Swedlow Engineering Co., Inc., would prepare a payroll summary, * * * and write a check for the net or 'take home' pay of each of its employees for the week immediately preceding. Each check bore a number, stated the amount for which it was payable and the name of the payee. The numbers of the checks issued to meet the payroll items were set forth in the left hand margin of the payroll summary. The payroll summary with

> a list and description of the checks drawn to cover its items was then forwarded to the defendant, Fireman's Fund Indemnity Company, with the request that it meet said payroll by authorizing the payment of said checks. Upon receipt of said payroll summary and list of checks with the accompanying request that they be made good, Fireman's Fund Indemnity Company drew its draft [14] payable to Broadway State Bank, for an amount exactly sufficient to cover the payroll checks and other checks drawn by Swedlow Engineering Co., Inc., and transmitted said draft together with the list of the checks to be paid from the proceeds of said draft to Swedlow Engineering Co., Inc.'s bank, the Broadway State Bank, 8564 South Broadway, Los Angeles, California, with instructions that the proceeds of said draft be used by said bank to make good the described checks and nothing else."

Under this arrangement the bonding company patently had just as much control over the payment of the individual payroll checks written by the contractor and which were covered by the bonding company's draft as would have been the case had the bonding company written individual checks of its own to cover the payroll.

Assuming, *arguendo,* that the mechanics of countersigning one check for the total net payroll rather than countersigning the individual payroll checks constitutes a substantial factual difference, it is clear that this difference is without legal significance. This is illustrated not only in this Circuit by *Westover v. William Simpson Const. Co., supra,* but in other Circuits by such

cases as *Phinney v. Southern Warehouse Corporation,* 212 F. 2d 488 (5th Cir. 1954). In that case the taxpayer was the owner for whom the work was being performed. The contract called for progress payments less a 15% retention to be held by the owner as security for completion of the contract. The contractor got into financial trouble and prevailed on the owner to advance a portion of the retentions to permit the job to be completed. The owner, with the consent of the surety, deposited funds in a special checking account to be used to pay bills and wages incurred on the job. Withdrawals were authorized under the signature of an employee of the contractor and an agent of the owner. The Circuit Court affirmed the decision of the District Court that the owner did not become the employer of the employees of the contractor under this arrangement, citing *Westover v. William Simpson Construction Co., supra.* In this case the argument of the Government was that the arrangement "took away from Gaddy, [the contractor] power as an independent contractor to dispose of the funds advanced according to his own judgment * * *." In other words, the Government contended the owner had a "veto power." The Courts found no merit in this argument.

In *Reliance Insurance Co. v. United States, supra,* Coast Pipeline Contractors became unable to meet its payrolls. It went to its surety for financial assistance. [Tr. 216-218.] The surety covered the outstanding payroll checks by drafts and then made arrangements to lend additional funds to the contractor. [Tr. 72-74.] Commencing in June, 1954, the surety loaned money to cover part of the payrolls of the contractor by depositing funds in the bank account of the contractor. Checks

were drawn on this account over the signature of the contractor's office manager and the countersignature of the surety's representative. [Tr. 75-76.] On these facts, and despite the apparently strong feelings of Judge Harris as to what the law should be, as noted above, he held that the surety did not have control over the payment of the wages and did not become the employer of the contractor's employees within the meaning of the statute.

If this is the law where the plaintiff taxpayer suing for a refund has in fact advanced the money, *a fortiori,* it should be, and it is submitted is, the law where the taxpayer has not advanced the money.

The Withholding tax provisions were enacted as part of the Current Tax Payment Act of 1943. The conference report makes it clear that the exception to the general definition of "employer" contained in Section 1621(d)(1) was primarily intended to cover certain special cases where the wage payments are not under the control of the person for whom the services were performed, as, for instance, in the case of certain types of pension payments. In the House bill it was provided that if the wages were paid by a person other than the person for whom the services were performed, the term 'employer" meant the person paying such wages. The Senate bill restated the exception in order to make celar that it was designed solely to meet unusual situations and not intended as a departure from the basic purpose to centralize responsibility for withholding, returning, and paying the tax and furnishing receipts. The pertinent portion of this report is set forth in the appendix. It is referred to here as a clear indication that the "control" referred to in the statute as defining the term

"employer" means primarily the *person paying* the wages. In this case, the Taxpayer was not the person paying the wages. Further, it did not have the "control" over such payments required by the statute. Finally, although the Taxpayer vigorously denies that the Subcontractor was the "captive of plaintiff", who at all times controlled the Subcontractor's ability to pay taxes, wages and materialmen, as contended by the Government, this would not make the Taxpayer the "employer," assuming it were true. This is the same argument advanced by the Government in the *Fireman's Fund* and *Southern Warehouse* cases. This argument has uniformly been rejected by this Court and other Courts.

Conclusion.

On the Taxpayer's appeal it is submitted that the District Court's decision was in error in holding that the Taxpayer was the "employer" of the employees of the Subcontractor between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a) and 1623 of the Internal Revenue Code of 1939, as amended, and that the Taxpayer was entitled to take nothing with respect to Withholding taxes and interest paid by the Taxpayer to defendant for this period. This portion of the decision should be reversed. The remainder of the decision should be affirmed.

Respectfully submitted,

ARTHUR H. DEIBERT,
A. L. BURFORD, JR.,
Attorneys for Taxpayer.

APPENDIX.

Statutes Involved.

Subchapter D—Collection of Income Tax at Source of Wages.

Sec. 1621, Internal Revenue Code of 1939, as amended, 26 U. S. C. 532—DEFINITIONS.

As used in this subchapter—

(a) *Wages.*—The term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid— * * *

(b) *Payroll Period.*—The term "payroll period" means a period for which a payment of wages is ordinarily made to the employee by his employer, and the term "miscellaneous payroll period" means a payroll period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual payroll period.

* * *

(d) *Employer.* The term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for the purposes of subsection (d)) means the person having control of the payment of such wages;

* * *

Sec. 1622, Internal Revenue Code of 1939, as amended, 28 U. S. C. 535. Income Tax Collected at Source.

(a) *Requirement of Withholding.*—Every employer making payment of wages shall deduct and withhold upon such wages a tax equal to: [Formula omitted.]

* * *

Sec. 1623, Internal Revenue Code of 1939, as amended, 26 U. S. C. 558. Liability for Tax.

The employer shall be liable for the payment of the tax required to be deducted and withheld under this subchapter, and shall not be liable to any person for the amount of any such payment.

Regulations

U. S. Treas. Reg. 120, Sec. 406.205 (December 22, 1953).

EMPLOYER.—

(a) The term "employer" means any person for who an individual performs or performed any service, of whatever nature, as the employee of such person.

(b) It is not necessary that the services be continuing at the time the wages are paid in order that the status of employer exist. Thus, for purposes of withholding, a person for whom an individual has performed past services for which he is still receiving wages from such person is an "employer."

(c) If the person for whom the services are or were performed does not have legal control of the payment of the wages for such services, the term "employer" means (except for the purpose of the definition of "wages") the person having such control. For example, where

wages, such as certain types of pensions or retired pay, are paid by a trust and the person for whom the services were performed has no legal control over the payment of such wages, the trust is the "employer."

(d) The term "employer" also means (except for the purpose of the definition of "wages") any person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States (including Puerto Rico as if a part of the United States).

(e) It is a basic purpose to centralize in the employer the responsibility for withholding, returning, and paying the tax and furnishing the statement required under Section 1633. The foregoing two special definitions of the term "employer" are designed solely to meet unusual situations. They are not intended as a departure from the basic purpose.

(f) An employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group, or entity. A trust or estate, rather than the fiduciary acting for or on behalf of the trust or estate, is generally the employer.

(g) The term "employer" embraces not only individuals and organizations engaged in trade or business, but organizations exempt from income tax, such as religious and charitable organizations, educational institutions, clubs, social organizations and societies, as well as the governments of the United States, the States, Territories, Puerto Rico, and the District of Columbia, including their agencies, instrumentalities, and political subdivisions.

Committee Reports

Extract from H.R. 510, 78th Cong., 1st Sess. (Conf. Rept.) 1943 Cum. Bull. 1351, 1353:

"Section 465(c) and (e) of the Code contains definitions of the terms 'withholding agent' and 'employer,' respectively. Under the House bill and under the bill as passed by the Senate, the definition of withholding agent has been eliminated. Both bills generally define the term 'employer' to mean the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person. This general definition is not adequate, however, to cover certain special cases, such as the case where the local agent of a nonresident alien individual, foreign partnership, or foreign corporation pays wages to a citizen or resident of the United States, and the case of the person making payment of wages in situations where the wage payments are not under the control of the person for whom the services are or were performed, as, for instance, in the case of certain types of pension payments. The House bill provided for these cases by an exception to the general definition of the term 'employer' which provided that if the wages are paid by a person other than the person for whom the services are or were performed, the term 'employer' means the person paying such wages. The Senate bill has restated the exception in order to make clear that it is designed solely to meet unusual situations and not intended as a departure from the basic purpose to centralize responsibility for with-

holding, returning, and paying the tax and furnishing receipts.

Accordingly, the Senate bill provides in Section 1621 (d)(1) that if the person for whom the services are or were performed does not have control of the payment of the wages for such services the term 'employer' means the person having control of the payment of such wages. Section 1621(d)(2) provides that in the case of a person who pays wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, which is not engaged in trade or business within the United States the term 'employer' means the person who pays the wages.

"As stated, Section 1621(d) makes it clear that the responsibility for withholding, paying, and returning the tax and furnishing receipts rests with the employer, except as otherwise specifically provided in section 1624. In the case of a corporate employer having branch offices, the branch manager or other representative may actually, as a matter of internal administration, withhold the tax or prepare the receipts required under section 1625, but the responsibility and legal duty for withholding, paying, and returning the tax and furnishing the receipts rests with the corporate employer."

Order for Judgment in Favor of Plaintiff.

In the District Court of the United States for the Northern District of California, Southern Division.

Reliance Insurance Company, a corporation, Plaintiff, v. United States of America, Defendant. No. 37234.

Plaintiff seeks to recover a refund of substantial employment taxes distrained by defendant upon plaintiff's bank account following a summary assessment against plaintiff in 1956. Defendant prepared the assessment, based upon plaintiff's alleged liability for withholding and social security taxes as an "employer" for the third quarter of 1954. During this period plaintiff, bonding company for Coast Pipeline, controlled the financial affairs of the latter corporation because of its probable insolvency and its monetary difficulties.

The legal question confronting the court arises out of the diverse interpretation by the parties of the term "employer" as set forth in 26 U.S.C.A. 1621, the section under which defendant acted in fixing plaintiff's liability for the disputed taxes. The legal principles, contained in the statutory definition itself and established by case law, have construed the term "employer" in a manner which excludes a corporation in plaintiff's position from being encompassed within the scope of Section 1621. (a) Phinney v. Southern Warehouse, 212 F.2d 488; (b) William Simpson Const. Co. v. Westover, 100 F. Supp. 125, aff. 209 F.2d 908(9); (c) American Fidelity

Co. v. Delaney, 114 F. Supp. 702.[1] Any departure from a strict application of the controlling principles in these decisions, regardless of the equities, results in quick reversal (Fireman's Fund v. United States, 100 F. Supp. 796).

The pattern of plaintiff's conduct, through its representatives who took over the helm of Coast Pipeline during the period of financial crisis in 1954, was such as to place it within the legal protection afforded and delineated by the adjudicated citations, supra. In fact, the evidence points to behavior by plaintiff both planned and ingeniously carried out to avoid tax liability.

However unconscionable plaintiff's conduct may be in avoiding a just obligation due the government for withholding and social security taxes owed employees Coast Pipeline, nevertheless defendant cannot prevail under the evidence before the court. Instead, the government must look to relief—at least in the future—through legislative remedies which have long since been enacted by California state authorities to protect tax obligations of a like character.

Accordingly, It Is Ordered that judgment be entered in favor of plaintiff for a refund in the amount of

---

[1](a) Bonding company paying employees of contractor held not "employer"

(b) Contractor held entitled to recover taxes collected on wages paid subcontractor's employees

(c) Bonding company, though assisting financially in completion of project, held not to be "employer" for tax liability

$23,642.05, together with interest from the date of payment. Plaintiff shall prepare findings of fact, conclusions of law and judgment consistent with this order.

Dated: November 27, 1959.

GEORGE B. HARRIS,
United States District Judge

Original filed Nov. 20, 1959. Clerk, U. S. Dist. Court, San Francisco.

I hereby certify that the annexed instrument is a true and correct copy of the original on file in my office.

Attest:

JAMES P. WELSH
Clerk, U. S. District Court
Northern District of California

By /s/ JOSEPH A. BAVARESCO
JOSEPH A. BAVARESCO
Deputy Clerk

[Seal]

Dated Nov. 28, 1961.